

Editor's note: Reconsideration granted; decision vacated in part; case remanded --See Order at 121 IBLA 285A (Feb. 3, 1994) below.

PHILLIPS PETROLEUM CO.
PHILLIPS 66 NATURAL GAS CO.

IBLA 90-242

Decided November 19, 1991

Appeal from a decision of the Deputy to the Assistant Secretary - Indian Affairs denying appeals from final orders of the Area Manager, Dallas Area Compliance Office, Minerals Management Service, determining royalty underpayment, directing recalculation of royalties, and assessing late payment interest. MMS-87-0423-IND, MMS-87-0498-IND.

Affirmed in part, set aside and remanded in part.

1. Oil and Gas Leases: Royalties: Processing Allowance

Under 25 CFR 211.13 and 30 CFR 206.106 (1986), the processing allowance for royalty on products from wet gas is determined on the basis of actual costs, not to exceed two-thirds of the value of the produced liquids.

2. Oil and Gas Leases: Royalties: Interest--Payments: Generally

MMS is authorized to impose a late payment charge when it determines that a royalty payor has failed to pay timely the proper amount of royalty due on the value of the production of wet gas.

3. Administrative Procedure: Administrative Record--Administrative Procedure: Administrative Review--Appeals: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Payments--Rules of Practice: Appeals: Generally

When the record does not confirm that a lessee has been assigned or assumed legal responsibility for making royalty payments on behalf of co-lessees, an MMS decision directing the lessee to recalculate the royalties for all co-lessees will be set aside and the case remanded for recalculation by the appropriate party or parties.

APPEARANCES: Jennifer S. Goering, Esq., and T. L. Cubbage II, Esq., Phillips Petroleum Co., Bartlesville, Oklahoma; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., U.S. Department of the Interior, Office of the Solicitor, Washington, D.C., for Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE IRWIN

Phillips Petroleum Company (Phillips) and Phillips 66 Natural Gas Company (Phillips 66) appeal the January 2, 1990, decision of the Deputy to the Assistant Secretary - Indian Affairs (Operations), 1/ denying appeals from final orders of the Area Manager, Dallas Area Compliance Office, Minerals Management Service (MMS), dated September 18 and November 10, 1987, determining royalty underpayment, directing recalculation of royalties, and assessing late payment charges.

Involved is the period from January 1979 through June 1987 when Phillips owned part interest in 12 Indian oil and gas leases and purchased the remaining wet gas production from the other co-lessees. Phillips also owned and operated the Norge Gas Plant through which the gas produced from the leases was processed. In 1986, Phillips 66 acquired all of Phillips' interest in Norge and in the contracts for purchase of the production from the leases. Phillips 66 then remitted royalties on behalf of Phillips and the other lessees in accordance with the gas purchase contracts. In June 1987, Norge was shut down and Phillips 66 shifted processing to another plant.

According to Phillips, from 1979 through 1982 the royalty payments remitted for it and the other lessees were based on the gross proceeds received. Pursuant to an MMS directive in 1982, Phillips began to use the "net realization method" to calculate royalty payments. A 1987 MMS review of Phillips' royalty payment calculations for production from the 12 leases for the test months of January 1984, June 1984, and January 1985 disclosed that Phillips routinely used a manufacturing (processing) allowance of two-thirds of the value of the liquid products (e.g., propane and butane) in computing royalty.

By letter dated April 28, 1987, MMS, quoting 30 CFR 206.106 and 25 CFR 211.13 (see below), requested Phillips to provide calculations and support for the two-thirds manufacturing allowance. Phillips responded on May 28, 1987, that this request was

not pertinent to royalty valuation [because] the regulations state "such allowance to be two-thirds of value of the marketable product unless otherwise determined by the Secretary." USGS and MMS have accepted this basis for valuation for years and have never determined an alternate allowance.

On September 18, 1987, MMS disallowed the allowance and directed Phillips to pay additional royalties in the amount of \$3,412.86 on the production from the 12 leases during the 3 test months and to recalculate royalties

1/ Pursuant to the appeals procedures set forth in 30 CFR 290.6, appeals of final orders issued by MMS involving Indian lands are to be reviewed by the Commissioner of Indian Affairs. Copies of the decision were mailed by MMS under its cover letter dated Jan. 9, 1990.

on those leases for the other months in the period from January 1979 through June 1987 based on 100 percent of the product value, i.e., with no exclusion for the unsupported manufacturing allowance. Phillips, together with Phillips 66, appealed that order in accordance with 30 CFR 290.2. The appeal was docketed as MMS-87-0423-IND.

On November 10, 1987, MMS issued an order (Bill No. 83847036) directing Phillips to pay late payment charges in the amount of \$1,427.80 for the underpayment of royalties for the 3 test months. Phillips' appeal of that assessment was docketed as MMS-87-0498-IND. Both appeals were consolidated and resulted in the January 2, 1990, decision from which appellants have appealed.

In their statement of reasons (SOR), dated February 13, 1990, appellants argue (1) MMS has incorrectly departed from its past practice and applicable regulations for calculating royalty payments; through interpretations, applications, and amendments subsequent to the initial rule adopted in 1920, the Department has established that the royalty required for processed gas should be computed on the value of all the residue gas and one-third of the resulting liquid hydrocarbons; (2) MMS cannot retroactively apply its new policy regarding the manufacturing allowance; (3) MMS is not entitled to assess a late payment charge in this situation; (4) Phillips is not responsible for royalty due from the other lessees; rather, due process requires MMS to notify each lessee and lease obligations do not extend to Phillips just because it purchased the gas at issue; and (5) Phillips cannot be required to conduct a "self-audit."

MMS contends that appellants' arguments regarding the processing allowance ignore recent Board decisions stating that the allowance is to be based on actual costs.

The leasing statutes for Indian lands, 25 U.S.C. §§ 396, 396a - 396g (1988), reserve to the Secretary the authority and responsibility to establish reasonable value for royalty purposes. See, e.g., California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961). 2/ In the earliest version of regulations implementing the Mineral Leasing Act of 1920, the Secretary provided that the value of "casing-head gas" (wet gas) for computing royalties would be either one-third of the value of marketable liquid hydrocarbons recovered from the gas, or the price received by the lessee for the casing-head gas if higher than the equivalent of the one-third value. 47 L.D. 552, 555 (1920). Recognizing that subsequent valuation methods have been based upon the above formula, Departmental regulations at 25 CFR

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In 1987 MMS was responsible for collection of royalties, for determining royalty liability, for maintaining accounting records, for audits of royalty payments or obligations, and for any and all other functions relating to royalty management "on Federal and Indian oil and gas leases." 30 CFR 201.100 (1986). Therefore, the regulations governing Indian leases and those governing MMS' responsibilities should be consistently construed and applied unless their provisions differ materially.

211.13 (1986), "[i]n determining the value for royalty purposes of products * * * that are derived from treatment of gas," provided for "a reasonable allowance for the cost of manufacture * * * [of] two-thirds of the value of the marketable product unless otherwise determined by the Secretary."

[1] In Wexpro Co., 106 IBLA 57, 61-66 (1988), the Board summarized the history of "wet gas" royalty valuation, including the manufacturing, or processing, allowance permitted by the Secretary. In Wexpro, 106 IBLA at 67, the Board indicated that 30 CFR 206.106 (1986) sets forth the processing allowance established by the Secretary. That regulation provides:

A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required.

Relying on the Wexpro decision and 30 CFR 206.106 (1986), the Board addressed the processing allowance issue in Phillips Petroleum Co., 109 IBLA 4, 9-10 (1989), decided in May 1989:

Phillips argues that MMS has unlawfully abandoned its regulations and past practice by applying a manufacturing or processing allowance based on actual costs instead of allowing two-thirds of the value of the NGLP's [natural gas liquid products] as a manufacturing allowance. Phillips attempts to establish that Departmental regulations have never authorized royalties to be based on more than one-third the value of the NGLP's, plus 100 percent of the value of the residue gas. It argues that the Department has historically allowed a manufacturing allowance of two-thirds the value of the NGLP's, regardless of the actual cost of manufacture. Phillips is simply wrong in its contention.

In Wexpro Co., supra, and Kerr McGee Corp., [106 IBLA 72 (1988)], we outlined the history of the relevant wet gas regulations from the time of enactment of the Mineral Leasing Act of 1920 to the present. As we stated in Wexpro Co., supra at 63:

The Secretary republished the 1936 oil and gas regulations, effective June 1, 1942, with only minor changes, and they were codified in the Code of Federal Regulations at Title 30. 7 FR 4132 (June 2, 1942). Those regulations remained in effect, virtually unchanged, except for CFR section numbers, until 1988 (see discussion infra). Thus, from early on the Departmental regulations in 30 CFR provided for collection of royalty on wet gas based on the greater of the lessee's proceeds from the sale of wet gas, if it was sold that way, or

the combined value of the dry residue gas after processing and one-third of the liquids extracted (or more than one-third, if the lessee's share was greater than one-third). [7/] [Emphasis supplied.]

Therefore, the applicable regulation, 30 CFR 221.51 (1976) (later 30 CFR 206.106), at all times during the time period of the audit at issue required a processing allowance of less than two-thirds the value of the liquids when the costs of manufacture were less than that amount. 8/ Both MMS and this Board are required to comply with duly promulgated regulations. See Conoco, Inc., 103 IBLA 108, 109 (1988); Western Slope Carbon, Inc., 98 IBLA 198 (1987).

Phillips also cites various letters of instruction from MMS, arguing that these letters establish a history and practice of basing royalty on one-third the value of the NGLP's plus 100 percent of the value of the residue gas (Statement of Reasons (SOR), Appendices A and C). Despite this claim by Phillips, many of those letters include the parenthetical phrase: "or the lessee's portion if greater than one-third," which is consistent with the applicable regulation. Clearly, Phillips cannot rely on those letters to justify a departure from its obligations under the applicable regulations. Phillips' interpretation of the regulations is not binding on the Department. The Government retains the authority under the regulations to reduce the allowance where the lessee's share of the liquids was greater than one-third. Even if it could be concluded that

7/ The next sentence [of the Wexpro decision] reads: "Despite the consistency in the regulatory language, the Department, through the Conservation Division, [Geological Survey] GS, and later MMS, indulged in various valuation methods." Wexpro Co., supra at 63. However, it is not clear that automatic application of a manufacturing allowance equal to two-thirds of the value of the liquids, despite the fact that the lessee's actual costs were less than that, was ever one of the "various valuation methods" utilized, and even if it were, it would not negate MMS' reliance on the regulation.

8/ The processing allowance provisions are now located at 30 CFR 206.158 and 30 CFR 206.159. The current regulations, although substantially changed from those in effect during the audit period, set two-thirds of the value of the liquids as the ceiling above which the processing allowance may not rise. If actual processing costs are less than two-thirds the value of the NGLP's, the processing allowance is also less than that amount. See 53 FR 1281-84 (Jan. 15, 1988).

Phillips had been given erroneous advice, it is also well established that the Secretary is not bound by erroneous advice provided by his subordinates. Peabody Coal Co., 93 IBLA 317, 323, 93 I.D. 394, 398 (1986).

We therefore reject appellant's argument that the Department is without authority to apply a processing allowance of less than two-thirds the value of the NGLP's produced.

The Board affirmed the MMS ruling that a processing allowance for extraction of NGLP's is to be determined on the basis of actual costs, not to exceed two-thirds of the value of the liquids. 109 IBLA at 17.

Phillips Petroleum Co., *supra*, involved one of the appellants in this appeal, which was represented by one of the same counsel. Nevertheless, we find virtually the same arguments presented in this appeal; no reasons are provided for distinguishing the situation here from that decision. We therefore follow the decision in Phillips and reject the argument that appellants are due a two-thirds processing allowance without demonstrating their costs in determining the value of the liquid products from these leases for royalty purposes.

The fact that royalty may have been accepted in the past without objection to the method of calculating royalty does not obviate MMS' duty to ensure proper payment or waive its authority to later subject the payments to audit. Nor does declining to continue to accept payments on the previous basis constitute the retroactive application of a new rule. See Shoshone Indian Tribe v. Hodel, 903 F.2d 784, 788 (10th Cir. 1990); Cities Service Oil & Gas Corp., 117 IBLA 17, 44-45, 97 I.D. 243, 259-60 (1990); Cities Service Oil & Gas Corp., 113 IBLA 255, 260-61 (1990).

[2] Appellants assert it is unfair for MMS to assess late payment charges when Phillips paid royalty in accordance with the long-standing practice of the Department and the specific instructions of MMS personnel. Appellants' arguments parallel those made in Phillips, where the Board held that MMS properly assessed late payment charges. 109 IBLA at 16-17. Section 111(a) of the Federal Oil and Gas Royalty Management Act (FOGRMA), 30 U.S.C. § 1721(a) (1988), specifically provides that "where royalty payments are not received by the Secretary on the date that such payments are due, or are less than the amount due, the Secretary shall charge interest on such late payments or underpayments * * * ." See also 30 CFR 221.80 (1986); Dugan Production Corp. (On Reconsideration), 117 IBLA 153, 154 (1990). As for periods prior to enactment of FOGRMA, the Department had independent authority to make a unilateral determination of interest owed. See Yates Petroleum Corp., 104 IBLA 173, 176 (1988); Atlantic Richfield Co., 21 IBLA 98, 107, 111, 82 I.D. 316, 320, 322 (1975). To the extent that appellants paid royalty employing a processing allowance to which they are not entitled, MMS is authorized to assess late payment charges.

[3] Appellants acknowledge that Phillips owned partial interests in the leases and, pursuant to gas purchase contracts, purchased the production attributable to the other owners (co-lessees) and remitted royalty for itself and the other owners for all the production from the leases, which was processed at the Norge gas plant. Appellants argue, however, that the co-lessees remain responsible under the leases for any underpayment of royalty for production owned by the co-lessees even though Phillips remitted royalty on their behalf.

MMS responds that under our decision in Forest Oil Corp., 113 IBLA 30 (1990), 3/ appellants are liable "for the royalty due on the share of production attributable to Phillips' co-lessees as a result of Phillips undertaking to pay those royalties on the co-lessees' behalf" (Answer at 10-11). MMS states: "Forest [Oil Corp.], as did Phillips, notified MMS of its responsibility to pay all royalties from the leases by filing a payor information form (PIF)." Id. at 10.

The record, however, does not contain any PIF's. Nor is there any other indication that Phillips assumed legal responsibility for the co-lessees' royalties. The copies of the Division Orders in the record provide only, in Paragraph Third, that before Phillips makes payment to the other owners "there shall be deducted therefrom any severance, gross production, occupation or other tax imposed on the production or purchase or sale of said oil." Royalties are not mentioned.

In Forest Oil Corp., supra, Forest was the named unit operator under an agreement that specified payment of royalties as one of its obligations. In fulfilling that obligation, Forest filed a PIF indicating it was responsible for all royalties. 4/ On that basis we held that Forest fell within the definition of "lessee" as "any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 U.S.C. § 1702(7) (1988). Forest Oil Corp., supra at 39-41. In this case it is not apparent from the record that Phillips was assigned or assumed legal responsibility for payment of royalties for all owners of interests in the

3/ The decision was reconsidered on other grounds in Forest Oil Corp. (On Reconsideration), 116 IBLA 176, 97 I.D. 239 (1990), and reaffirmed, and subsequently reviewed by the Director, Office of Hearings and Appeals, and reversed. Forest Oil Corp., 9 OHA 68, 98 I.D. 248 (1991). See also Mesa Operating Limited Partnership, 98 I.D. 193 (1991).

4/ MMS has provided that

"[a] PIF must be filed for each Federal or Indian lease on which royalties * * * are paid to the AFS [Auditing and Financial System]. The payor is required to submit a PIF to establish or revise royalty and rental payment responsibility. Generally, an initial or revised PIF is required when physical, contractual, and operational events occur or conditions are revised regarding a lease, its subdivisions, or its payment responsibilities."

1 MMS, Royalty Management Program, Oil and Gas Payor Handbook § 2.4 (1987).

leases. If appellants are not legally responsible for the co-lessees' royalties, then it follows that MMS cannot direct appellants to calculate the royalties owed by the co-lessees for the period involved. That obligation would fall on each of the owners of the leases for their proportionate share of production. ^{5/} We therefore set aside that part of the MMS decision requiring appellants to recalculate royalties for the months not covered during the period involved, and remand the matter for a recalculation of royalties by the appropriate party or parties based on the actual costs of the processing and of the associated late payment charges. See, e.g., Shell Offshore, Inc., 113 IBLA 226, 233-34, 97 I.D. 73, 77-78 (1990). Presumably the co-lessees, as well as appellants, can employ cost figures from the Norge gas plant to establish the processing allowance to which they are entitled, since all production from the leases was processed at that plant. ^{6/}

Therefore, in accordance with the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed in part and set aside and remanded in part for action consistent with this decision.

Will A. Irwin
Administrative Judge

I concur:

David L. Hughes
Administrative Judge

^{5/} See 25 CFR 211.17: "Lessees may make arrangements with the purchasers of oil for the payment of the royalties to the superintendent by such purchasers, but such arrangement, if made, shall not operate to relieve a lessee from responsibility should the purchaser fail or refuse to pay royalties when due."

^{6/} If appellants are legally responsible for payment of all royalties, we see no objection to their being required to calculate the processing costs for all production and the resulting royalties. See Cities Service Oil & Gas Corp., *supra*, 113 IBLA at 261. Because the processing allowance requires a determination of costs, it is necessary for the party calculating the royalty payments to demonstrate the actual processing costs or the value of the products achieved from processing in order to establish the allowance.

February 3, 1994

IBLA 90-242	:	MMS-87-0423-IND. MMS-87-0498-IND
121 IBLA 278 (1991)	:	
	:	Recalculation of Royalties
PHILLIPS PETROLEUM CO.	:	
PHILLIPS 66 NATURAL GAS CO.	:	Petition for Reconsideration
	:	Granted
	:	
	:	Board Decision Vacated in Part;
	:	Case Remanded

ORDER

The Minerals Management Service (MMS) has filed a motion for partial reconsideration of our decision in Phillips Petroleum Co. & Phillips 66 Natural Gas Co., 121 IBLA 278 (1991), that set the portion of the January 2, 1990, decision of the Deputy to the Assistant Secretary--Indian Affairs (Operations) requiring Phillips to pay additional royalties for production from 12 Indian oil and gas leases for three test months and to recalculate royalties for its co-lessees from January 1979 - June 1987 (except for the three test months). We set this portion of the decision aside because the record did "not contain any PIF's [Payor Information Forms]. Nor is there any other indication that Phillips assumed legal responsibility for the co-lessees' royalties. * * * In this case it is not apparent from the record that Phillips was assigned or assumed legal responsibility for payment of royalties for all owners of interests in the leases." See 121 IBLA at 284-85. With its motion for reconsideration MMS filed copies of the PIF's that Phillips had submitted for ten of the 12 leases for which Phillips was the sole royalty payor and an MMS Special Request Aid Assignment Worksheet listing all PIF's filed on the 12 leases.

After our decision in Mesa Operating Limited Partnership, 125 IBLA 28, 99 I.D. 274 (1992), MMS requested that we suspend consideration of its motion for reconsideration of Phillips so that it could locate documents that would indicate an assignment, and we did so. Later MMS submitted a copy of its Request for Reconsideration in Mesa and copies of division orders to Phillips for the leases involved. MMS pointed out:

[T]he division orders expressly assign Phillips the responsibility to make royalty payments. The first page of each division order * * * that "Phillips shall give credit for said oil as per directions below:" Following this statement is a list of who gets credit and the division of interest. Included in each list is the royalty interest. Thus, the division order indicates that Phillips was assigned and accepted the royalty payment responsibility.

Supplemental Brief at 2.

121 IBLA 285A

We have today issued a decision in Mesa Operating Limited Partnership (On Reconsideration), 128 IBLA 174 (1994), in which we reaffirm our rejection of MMS' position that a person who holds no interest in a lease but who files a PIF has been assigned the responsibility for paying royalties on a lease. We said that "in the absence of a regulation and a PIF explicitly stating that filing a PIF constitutes the assumption of the lessee's obligation to pay royalty by the person filing it, a document evidencing the person's agreement to accept this responsibility is necessary." 128 IBLA at 182-83. We hold that view in this case also, where Phillips filed PIF's on behalf of its co-lessees. However, we held that a division order may constitute evidence that the obligation to pay royalty has been assigned. 128 IBLA at 184-85.

In this case the division orders, on Phillips letterhead, provide that "until further notice Phillips shall give credit * * * as per directions below" and credit the royalty interest to the Bureau of Indian Affairs for the credit of the successors in interest to various Indian allotments effective with the first production or first run of the leases and were approved by the Area Oil & Gas Supervisor, Geological Survey, in 1975 and 1976. Because we agree these division orders assign responsibility for payment of royalties to Phillips, we vacate the portion of our decision holding it was not apparent from the record that Phillips was assigned or had assumed legal responsibility for payment of its co-lessees' royalties.

However, we do not know from the record before us whether all of these division orders remained in effect for all of the January 1979 - June 1987 period MMS required Phillips to recalculate royalties on these leases. Accordingly, we remand the case for re-adjudication by MMS based on its determination of those facts. Shell Offshore, Inc., 113 IBLA 226, 233-34, 97 I.D. 73, 77-78 (1990).

Will A. Irwin
Administrative Judge

I concur:

David L. Hughes
Administrative Judge

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